How Public Regulation Changes Corporate Governance Practice?

The Corporate Board Reform in Taiwan

Yu-Hsin Lin*

Abstract

This paper takes the example of legal transplantation of independent directors in Taiwan and explores how public regulation affects (or not affect) corporate governance practice. The interview result reveals that (1) most independent directors are close friends of controlling shareholders, (2) they spend very limited time on corporate matters, and (3) they believe in the integrity of the controlling shareholder of the firm they serve. There exists tremendous information asymmetry between independent directors and controlling shareholders. The strong personal trust on controlling shareholders alleviates the concern of independent directors over transparency and information asymmetry. Controlling shareholders also tend to invite someone who they are familiar with to join the board as independent directors. Public regulation does change the landscape of corporate governance in Taiwan. However, only few companies welcome truly “independent” directors and expect them to actively participate in corporate matters. It is fair to say that the new regulation has created a market for independent directors in Taiwan. Nevertheless, it does not change much of the substantive corporate governance practice in Taiwan.

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Introduction

This paper takes the example of legal transplantation of independent directors in Taiwan and explores how public regulation affects (or not affect) corporate governance practice. Taiwan’s corporate law originally follows the two-tier board system where board of directors is a decision-making institution and statutory supervisor is a monitoring institution. However, most statutory supervisors of Taiwanese public companies have long been controlled by the controlling shareholders and failed to act as a corporate monitor. Since 2002, Taiwan gradually introduced the institution of independent directors to Taiwan’s corporate boards in order to strengthen the internal governance of Taiwanese public companies.

As of October 2009, 38.2% of the TSE-listed companies have at least one independent director on their board. In other words, there are still 61.8% of TSE-listed
firms choose not to have any independent director. As of October 2009, only 3.6% TSE-listed companies established audit committees to replace statutory supervisors. In sum, very few Taiwanese public companies completely switch to a U.S. style board structure. Majority of the firms stay with the original structure and prefer not to have “independent” directors on their boards. This paper focuses on companies who, whether voluntarily or not, introduce independent directors to their boards and assesses the effectiveness of these new independent directors.

I. Corporate Board Reform in Taiwan

A. Traditional Two-tier Board Structure

The corporate-board structure around the world has two major styles: the Anglo-American style and the German style, also known as the “one-tier system” and “two-tier system,” respectively. In general, the “Anglo-American style” board structure, notably that of the United States and the United Kingdom, relies on the board of directors and several sub-committees to monitor the management; the German structure relies on a supervisory board to monitor management board while management board focuses on managing the company. The structure of a given board is clearly path dependent in relation to the given country’s political and economic conditions. Many Asian countries follow the German-style governance structure because they first transplanted their corporate law from European legal systems.

The corporate-board structure of Taiwan generally follows the Japanese-style governance structure, which is a modified version of the German governance structure.
The governance structure in Taiwan and in Japan differs from the typical German governance structure in that the statutory-supervisor position in Japan and Taiwan is weaker than its German counterpart, the supervisory board. In Germany, the supervisory board has the right to appoint or remove directors; however, in Japan and Taiwan, supervisors are nominated by the board and elected by the shareholders.\textsuperscript{1} In addition, the statutory supervisors in Taiwan do not act collectively as a board as does their German or Japanese counterpart; rather, they act individually.\textsuperscript{2} According to the Corporation Law of Taiwan, a supervisor is an independent supervisory institution responsible for auditing the business conditions of companies and for evaluating the performance of companies’ boards of directors and managers.\textsuperscript{3} However, in Taiwan, a supervisor has the right only to attend board meetings, not the right to vote. In addition, the pre-reform law set no qualification for supervisors. In practice, many supervisors are relatives or friends of the founding family, the controlling shareholder, directors, or top managers. Therefore, most statutory supervisors of Taiwanese public companies are just “rubber stamps.”

B. The 2002 Reform

In the aftermath of Enron and other high-profile corporate-fraud cases, the U.S.

\textsuperscript{2} Japan reformed its statutory auditor system in 1993 to introduce a board of statutory auditors and require at least one member of the auditor board to be an outside auditor. Before that, statutory auditors in Japan act individually. \textit{Id.} at 347-48.
\textsuperscript{3} GONG SI FA [Corporation Law] art. 218, § 1 (2009) (Taiwan). “Supervisors shall supervise the execution of business operations of the company, and may at any time or from time to time investigate the business and financial conditions of the company, examine the accounting books and documents, and request the board of directors or managerial personnel to make reports thereon.”
The Corporate Governance Symposium

Congress, in enacting the Sarbanes-Oxley Act of 2002 (SOX), placed great reliance on outside/independent directors and audit committees as a means of monitoring both firms’ internal control system and the integrity of firms’ financial-reporting systems. Following the passage of SOX, many Asian countries, such as China, Japan, South Korea, and Taiwan, initiated corporate-board reforms to be in alignment with the U.S.-style governance structure. In response to local corporate-fraud scandals, Taiwan’s financial authority has considered introducing the institution of independent directors to enhance corporate-monitoring functions. In 2002, the Taiwan Stock Exchange (TSE) began taking a leading role in requiring all newly listed companies to have at least two independent directors and one independent statutory supervisor. However, the TSE is still hesitant to apply such requirements to all listed companies owing to fierce opposition from industry. Instead, the TSE adopted the “comply or disclose” approach to require all listed companies to disclose the TSE-defined “independence” of their directors and supervisors. Since then, more and more public companies have voluntarily retained independent directors and independent supervisors.

C. The 2006 Reform

The Taiwan government’s proposal for corporate-board reform has triggered much debate among scholars in Taiwan. The most prominent issue is whether or not Taiwan should introduce independent director and abandon the institution of statutory supervisor.4

4 Taiwan’s corporate scholars have different views on this issue. Some advocate the introduction of independent directors. See Syue-Ming Yu, Taiwan Shin Gong Si Fa yu Du Li Dong Shi (Shang) [New Taiwan Corporation Law and Independent Directors (1)], 123 FT L. REV. 63 (2002) (supporting transplantation of independent director because it is a global trend). Others propose an enabling approach to grant companies
Finally, the Congress settled the dispute by revising the Securities and Exchange Act in 2006 to give public companies the option to choose whether or not they have independent directors. In addition, public companies also have the option to choose whether or not they establish audit committees. And if they do, the law requires that the companies abandon the institution of statutory supervisor. The amendment basically resembles the option, but oppose having both independent directors and statutory supervisors in one company. See Wen-Yeu Wang, *She Li Du Li Dong Jian Dui Gong Si Zhi Li de Ying Xiang* [The Impact on Corporate Governance of Introducing Independent Directors and Statutory Supervisors], 56 THE L. MONTHLY 45 (2005) (supporting an enabling approach and suggesting that once the company chooses to introduce independent directors, it has to switch to a single board system and abandon the institution of statutory supervisors); Wang-Ruu Tseng, *Wo Guo You Guan Gong Si Zhi Li ji Xing Si* [Some Thoughts on Corporate Governance in Taiwan], 103 THE TAIWAN L. REV. 61 (2003). Still others oppose the introduction of independent directors and propose to strengthen the institution of statutory supervisors. See Ming-Jye Huang, *Gong Si Jan Kong yu Jan Cha Ren Jye Du Gai Ge Ren* [Innovation of Taiwan’s Corporate Auditor System - A Corporate Governance Perspective], 29 NATIONAL TAIWAN UNIV. L. J. 159 (2000) (Opposing the introduction of independent directors and purporting to strengthen the independence and monitoring function of statutory supervisors); Len-Yu Liu, *Jian Quan Du Li Dong Jian Shi yu Gong Si Ji Li zhi Fa Ji Yang Jiu* [Research on Building a Sound Legal System on Corporate Governance and Independent Directors and Statutory Supervisor], 94 THE TAIWAN L. REV. 131 (2003); Kuo-Chuan Lin, *Jian Cha Ren Xiu Zheng Fang Xiang zhi Jiang Tao* [Review of the Reform of Statutory Supervisors], 73 THE TAIWAN L. REV. 48 (2001).
2002 Japanese board reform, which also grants corporations the option to choose between a U.S.-style board structure and traditional board structure.\textsuperscript{7}

What distinguishes Taiwan’s reform from Japan’s reform is that the financial authority of Taiwan may deprive the choice of Taiwan’s public corporation whereas that of Japan may not. Specifically, Taiwan’s law grants the Financial Supervisory Commission (FSC) the right to mandate that any public corporation (1) have independent directors on the corporate board or (2) replace statutory supervisors with audit committees, which is made up of at least three independent directors with at least one possess financial expertise.\textsuperscript{8}

Hence, the ultimate policy goal in Taiwan is to align all public firms’ board structure with unitary board structure and to strengthen the monitoring function of corporate boards. In March 2006, the FSC has mandated that all public financial firms and those non-financial listed firms with equity value over NT$50 billion (US$1.6 billion) should have at least two independent directors on their board and that the total number of independent directors should be no less than one-fifth the number of board members.\textsuperscript{9} As of October 2009, there are a total of 279 TSE-listed companies whose boards have a combined total of 632

\begin{flushleft}
\textsuperscript{7} Gilson & Milhaupt, supra note 1, at 352-54.
\textsuperscript{8} ZHENG QUAN JIAO YI FA art. 14-2 & 14-4; Regulations Governing the Exercise of Powers by Audit Committees of Public Companies art. 4 (2006).
\textsuperscript{9} Financial Supervisory Commission, Jing-Kuan-Cheng-I-Tzu-0950001616-Hao, Mar. 28, 2006.
\end{flushleft}
independent directors. That is, 38.2% of the TSE-listed companies have at least one independent director on their board. In other words, there are still 61.8% of TSE-listed firms do not have any independent directors. Table 1 shows the breakdown:

Table 1 Breakdown of TSE-listed Firms that Have Independent Directors

<table>
<thead>
<tr>
<th>Number of Independent Directors in Each Firm</th>
<th>Number of TSE-listed Firms</th>
<th>Percentage (%) of Total TSE-listed Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>17</td>
<td>2.3</td>
</tr>
<tr>
<td>2</td>
<td>183</td>
<td>25.0</td>
</tr>
<tr>
<td>3</td>
<td>68</td>
<td>9.3</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>1.4</td>
</tr>
<tr>
<td>5</td>
<td>1</td>
<td>0.1</td>
</tr>
<tr>
<td>Total</td>
<td>279</td>
<td>38.2</td>
</tr>
</tbody>
</table>


Under current regulation, there are three types of board structure in Taiwanese public companies: (1) with independent directors and an audit committee (no statutory supervisor), (2) with independent directors and statutory supervisors (no audit committee), (3) with only statutory supervisors. In general, large companies (with equity value over NT$50 billion (US$1.6 billion)) and newly listed companies, which are generally much smaller in size, should have at least two independent directors on the board. Other companies have the option to choose among the three types.

II. Corporate Governance in Taiwan

The corporate environment in Taiwan is very different from that in the U.S. In short, corporate ownership is concentrated and family-dominated. The largest shareholders of the non-financial firms in Taiwan control 62.69% of the board seats and 49.55% of the statutory auditors. Hence, large shareholders in Taiwan not only own public firms, they also manage and control public firms. The average control rights of the largest shareholders in non-financial firms is 29.81%, however, the average cash-flow rights are only 22.13% (Table 2). This discrepancy provides an incentive and opportunity for controlling shareholders to tunnel corporate assets at the expense of minority shareholders.

Before the introduction of independent directors in 2002, many of the corporate boards in Taiwan functioned like paper meetings. The board members are either founding family members or top executives. Typically, family members are involved deeply in the management of the company.

Table 1: Comparison of Board Composition and Ownership Structure Between Financial Firms and Non-Financial Firms in Taiwan

<table>
<thead>
<tr>
<th>Panel A: Board Composition</th>
<th>Financial Firms</th>
<th>Non-Financial Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of Largest Shareholder as Directors</td>
<td>59.18</td>
<td>62.69</td>
</tr>
</tbody>
</table>

For example, Procomp Informatics Ltd., the subject of Taiwan’s largest corporate fraud case in 2004, is controlled by Su-Fei Yeh and her brother. Ms. Su-Fei Yeh is the chairperson and CEO of Procomp and her brother, Meng-ping Yeh is the vice chairperson. Among the five board members, the Yeh family holds two seats and the remaining three seats are all held by top executives of Procomp. In practice, the Yeh family controls the board and, in turn, the firm. Similarly, Xue-Ren Lu and his wife hold two seats of the five board seats of Infodisc Technology Corp., the subject of the second-largest corporate fraud case in 2004.

In theory, controlling shareholders, with major shareholdings, monitor the management more effectively and reduce agency costs greatly as long as their interests are in line with outside investors. Under this scenario, the interests of minority shareholders

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15 The general vote of the board only needs majority of the directors attending, and majority vote of the attended directors. That means Procomp’s board decisions could be made by Ms. Su-Fei Yeh and her brother as long as one other director attending the board meeting. GONG SI FA [Corporation Law] art. 206, § 1 (2009) (Taiwan). “Unless otherwise provided for in this Act, resolutions of the Board of Directors shall be adopted by a majority of the directors at a meeting attended by a majority of the directors.”
would not be sacrificed when the controlling shareholders dominate the board. However, if the control rights of the controlling shareholders exceed their cash-flow rights, as in the case of Taiwan and most other countries, the interests of controlling shareholders deviate from those of minority shareholders, creating a danger that minority shareholders could be expropriated.

This is exactly the danger in Taiwan’s corporate governance.\footnote{YEH & KO, supra note 13, at 294-95.} For example, in 2004, Ms. Su-Fei Yeh of Procomp and her brother controlled all five board seats while only held 7.83% of Procomp’s shares.\footnote{Ying-Hua Yeh, Zhengfa de Guwang [The Disappearing King of Stock Market] 92 (2005). [hereinafter Yeh, The Disappearing King]} Similarly, Mr. Lu of Infodisc controlled 80% of the board seats in 2004 while owning only 6.9% of the shares.\footnote{Id., at 144.} In both companies, the control rights of the largest shareholders far exceed their cash-flow rights, and such deviation reaches its peak before the corporate debacles. Table 3 shows the increasing pattern of such deviation over the years for Procomp and Infodisc.

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PROCOMP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of Board Seats Controlled by Largest Shareholders (A)</td>
<td>55.5%</td>
<td>55.5%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Percentage of Shareholding by Largest Shareholders (B)</td>
<td>15.48%</td>
<td>13.23%</td>
<td>10.32%</td>
<td>7.83%</td>
</tr>
<tr>
<td>Excess Control (A/B)</td>
<td>3.6</td>
<td>4.2</td>
<td>9.7</td>
<td>12.8</td>
</tr>
<tr>
<td><strong>INFODISC</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2 Excess Control of Procomp and Infodisc

17 YEH & KO, supra note 13, at 294-95.
19 Id., at 144.
<table>
<thead>
<tr>
<th>Percentage of Board Seats Controlled by Largest Shareholders (A)</th>
<th>100%</th>
<th>100%</th>
<th>80%</th>
<th>80%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of Shareholding by Largest Shareholders (B)</td>
<td>34%</td>
<td>19.5%</td>
<td>9.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Excess Control (A/B)</td>
<td>2.9</td>
<td>5.13</td>
<td>8.1</td>
<td>11.6</td>
</tr>
</tbody>
</table>

Source: Yeh, The Disappearing King, at 92, 144.

*a. Percentage of board seats controlled by largest shareholders refers to the percentage of directors that are largest shareholders, family members of the largest shareholders, or company employees.*

Business Groups

Another characteristic of Taiwan’s corporate ownership structure — business group — further provides channels for expropriation. Business groups control and contribute most to the economy of Taiwan. The top 100 business groups in Taiwan own more than 6,300 affiliated firms and hire more than 3 million employees in 2007. The total revenue of the top 100 business groups is 7.8 times that of Taiwan’s government in 2007. Their revenue growth in 2007, 16.01%, also far exceeds that of the GNP of Taiwan. Among the top 10 business groups, 9 are in the financial industry. Family business continues to dominate Taiwan’s economy. In terms of total asset value, family business groups account for 73.56% of the top 100 business groups. Seven major families in Taiwan control almost 40% of the total assets of the top 100 groups.

Given the importance of business groups to Taiwan’s economy, the corporate governance of business groups becomes vital. One of the key issues therein is the fairness

20 TAIWAN SECURITIES & FUTURES INSTITUTE, CORPORATE GOVERNANCE IN TAIWAN 5-6 (October 2009).
23 The major families include the Tsai family of Cathay and Fubon Groups, the Wu family of Shin Kong and Tai Shin Groups, the Wang family of Formosa Plastics Group, the Gu family of China Trust, Chailease, and Taiwan Cement Group, the Kuo family of Foxconn Group, the Hsu family of Far Eastern Group, and the Hsu family of Chi Mei Group. Id.
of the transactions among group firms. While sometimes these transactions facilitate the growth of business groups, they also provide channels for controlling shareholders to tunnel out corporate assets. Several business practices in Taiwan further provide controlling shareholders easy access to corporate assets without much oversight in place. For example, cross-shareholding between public parent companies and subsidiaries keeps public companies in stable management. Controlling shareholders can further control the board by electing subsidiaries as institutional directors or statutory supervisors, providing that the subsidiary assigns an individual representative to perform its duty. Individual representatives of such subsidiaries can also be elected as directors or statutory supervisors. Furthermore, more than one such individual representative can be elected as directors or statutory supervisors. Hence, through cross-shareholding, controlling shareholders can literally appoint anyone he/she wants to serve as directors and statutory supervisors and embezzle corporate resources without any internal oversight.

III. Legal Responsibilities of Independent Directors

In general, Taiwanese law requires independent directors to pay attention to internal audit procedures, material corporate transactions, matters on which directors or statutory

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24 Cross shareholding may help corporation to (1) maintain stable control of management, (2) facilitate human capital investment, (3) enhance the operational efficiency of strategic alliance with other firms (4) diversify risks, and (5) facilitate financial arrangements among group firms. Ming-Jye Huang, Jiao Cha Chi Gu v.s. Gong Si Jian Kong [Cross Shareholding v.s. Corporate Governance], in GONG KAI FA SHIN GONG SH FA ZHI YU GONG SI JIAN KONG [PUBLIC COMPANY REGULATION AND CORPORATE GOVERNANCE] 185, 194-203 (2001).

25 GONG SI FA [Corporation Law] art. 27, § 1 & 2 (2009) (Taiwan). "[I] Where a government agency or a juristic person acts as a shareholder of a company, it may be elected as a director or statutory supervisor of the company provided that it shall designate a natural person as its proxy to exercise, on its behalf, the duties of a director or statutory supervisor. [II] Where a government agency or a juristic person acts as a shareholder of a company, its authorized representative may also be elected as a director or statutory supervisor of the company; and if there is a plural number of such authorized representatives, each of them may be so elected.”
supervisors have conflicts, securities offerings, and the retention or dismissal of outside auditors or internal accounting, financial, and auditing officers. However, independent directors do not have veto rights to these decisions. They can only ask the board to keep their dissenting opinion on file. The board can still decide by majority votes even if independent directors have dissenting opinions.

In practice, dissenting opinions from independent directors are rare. Nevertheless, once the companies make such opinions public, the market and the government will watch carefully. Such opinions usually bear signaling effects. For example, one interviewee (and only one), who serves in the financial industry, reported that he once filed a dissenting opinion for the appointment of the CEO of a subsidiary. Although a majority of the board members voted for that candidate, the government authority overseeing the financial industry asked the firm to reconsider the appointment after reviewing the dissenting opinion. In the end, the firm withdrew the appointment.

Item 3 of Article 14-3 requires independent directors to review matters in which a director or statutory auditor bears a personal interest. In short, this clause deals with self-dealing transactions pertaining to directors and statutory auditors. Literally speaking, for

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26 ZHENG QUAN JIAO YI FA art. 14-3. “When a company has selected independent directors as set forth in paragraph 1 of the preceding article, then the following matters shall be submitted to the board of directors for approval by resolution unless approval has been obtained from the Competent Authority; when an independent director has a dissenting opinion or qualified opinion, it shall be noted in the minutes of the directors meeting:
1. Adoption or amendment of an internal control system pursuant to Article 14-1.
2. Adoption or amendment, pursuant to Article 36-1, of handling procedures for financial or operational actions of material significance, such as acquisition or disposal of assets, derivatives trading, extension of monetary loans to others, or endorsements or guarantees for others.
3. A matter bearing on the personal interest of a director.
4. A material asset or derivatives transaction.
5. A material monetary loan, endorsement, or provision of guarantee.
6. The offering, issuance, or private placement of any equity-type securities.
7. The hiring or dismissal of an attesting CPA, or the compensation given thereto.
8. The appointment or discharge of a financial, accounting, or internal auditing officer.
9. Any other material matter so required by the Competent Authority.”

27 Interview No. 25 (Mar. 1, 2009), at 3-4.
public companies that have independent directors, any matter that bears on the personal interests of directors or statutory auditors should be approved by the board of directors, and if independent directors have any opposing opinion, the board minutes should record them.

IV. What Do the Independent Directors Really Do?

Most of the independent directors I know actively participate in corporate matters. However, their participation usually limits to attending all the board meetings, actively participate in board meetings and reading materials in preparation for the meetings. I think most of the independent directors just do that much. I don’t think anyone would visit the firm if nothing comes up. And I don’t think anyone would look into details of the pre-meeting materials. 28

The above quote fairly reflects the reality of independent director participation in Taiwan. The standard tasks of independent directors are to attend board meetings, review meeting materials before the meeting, and review internal audit reports every month. In general, board meetings of firms in the financial industry are held once a month, while those in other industries are usually held every two to three months. Most interviewees admit that they didn’t spend much time reviewing materials before the meeting. However, if attending board meeting is the only major task for independent directors, the effectiveness of board meetings becomes crucial. Despite the fact that some independent directors are just too busy to preview the materials 29, sometimes it is because firms prefer not to provide all the detailed information outside the meeting for confidentiality reasons. 30

28 Interview No. 4 (Oct. 07, 2008), at 8.
29 i.e. Interview No. 29 (Oct. 21, 2009), at 10.
30 i.e. Interview No. 30 (Oct. 22, 2009). at 12.
Nevertheless, the confidentiality concerns could compromise the readiness of independent directors, who already are not that familiar with daily corporate matters, to effectively judge the fairness of board decisions.

In addition to attending board meetings, independent directors in Taiwan also review internal audit reports every month. Although some with accounting backgrounds pay more attention to the internal control systems, most interviewees reveal that such review is usually cursory and superficial. Some directors might not even have a clue how to review an internal audit report.

To be honest, I personally feel that the system of requiring independent directors to review internal audit report does not achieve much of its goal. For example, one company provides me with a report that lists every item as “no material irregularity” every month. To be honest, I really don’t know what to question further. On the other hand, the other company provides me with a very detailed report about what the internal auditor found and what he plans to do. My feeling is that on the one hand, I feel much better when I see the more detailed report; on the other, I don’t know what to question because you already handled all the issues.

In addition to directors’ individual abilities, the independence and ability of the internal auditor also influences the effectiveness of independent directors in overseeing the internal control process. Traditionally, the internal audit departments of most public

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31 Regulations Governing Establishment of Internal Control Systems by Public Companies art. 15 (2009.3.16), available at http://eng.selaw.com.tw/FLAWDAT0201.asp. “After having presented the audit and follow-up reports, a public company shall submit the same for review by the supervisors by the end of the month next following the completion of the audit items. A public company's internal auditors discovering any material violation or any likelihood of material damage to the company shall promptly prepare and present a report and notify the supervisors. If a public company has independent directors or an audit committee, when complying with the preceding two paragraphs, it shall simultaneously submit the materials or notification to the independent directors or the audit committee.”

32 Interview No. 26 (Oct. 12, 2009), at 7-8.
companies in Taiwan are supervised by general managers and thus are not as independent. On Dec. 19, 2005, the FSC of Taiwan revised the “Regulations Governing Establishment of Internal Control Systems by Public Companies” requiring the internal audit departments of all public companies to be directly supervised by the board. The revision formally enhances the status and independence of internal auditors and provides a better structure for internal auditors to ensure the functioning of the internal control system.

In sum, the participation of independent directors generally limits to attending board meetings and reviewing monthly internal audit reports. In companies that adopted the board committee system, independent directors, as members of the audit committee, play a more active role in overseeing the financial condition of the company. Nomination committee and compensation committee are still few in Taiwan. In addition, since the Taiwanese court has not adopted the business judgment rule and deferred to the decisions of independent board committees in situations involving conflicts of interest, such as mergers and acquisitions and shareholder derivative suits, independent directors in Taiwan have not played an active role in reconciling matters that involve conflicts of interest. Therefore, the contribution of independent directors to the company is less valued in Taiwan than in the United States.

V. Social Ties and Structural Bias

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33 Regulations Governing Establishment of Internal Control Systems by Public Companies art. 11 (2009.3.16), available at http://eng.selaw.com.tw/FLAWDAT0201.asp. “A public company shall establish an internal audit unit under the board of directors, and shall appoint qualified persons in an appropriate number as full-time internal auditors according to size, business condition, management needs, and other applicable laws and regulations. A public company shall report any appointment or discharge of internal audit officers for passage by the board of directors, and shall report such information to the FSC for recordation via the Internet-based information system by the 10th day of the month next following passage by the board of directors. The requirements for the qualified full-time internal auditors referred to in paragraph 1 shall be as prescribed separately by the FSC.”
To avoid joining a “bad” company, independent directors would screen the firms beforehand. The key criterion used by independent directors in Taiwan is the integrity of the controlling shareholders and managers.

How do I decide whether to take on the position? First thing is the integrity of the leader. If the leader or the management team always follows the rules, the job of the independent director becomes easier because the cost of monitoring is not high.34

They usually judge such integrity from the personal relationship between them. More than 55% of the interviewees have personally known the chairman/CEO or major shareholder of the firm for more than ten years. The trust is built on a long-term understanding of each other. The strong personal trust of controlling shareholders alleviates the concern of independent directors over transparency and information asymmetry.

If you doubt every report presented to you, it would be endless. If everything needs to redo, the cost would be too high. I think the trust towards the management should be built on the long-term personal understanding and trust on the integrity of that person. In addition, the company should perform well. Based on these two assumptions, the independent directors can monitor (the company) and make reasonable judgment.35

The strong personal ties between independent directors and controlling shareholders may be an inevitable result of the introduction of a new outside institution to a controlled or family-dominated board. However, such close relationships in turn raise concerns over

34 Interview No. 7 (Oct. 12, 2008), at 1. See also Interview No. 14 (Nov. 11, 2008), at 2. (“I have my own criteria, that is that person must be the one who I can trust and has good reputation, otherwise, I do not dare to join……. I think the attitude of the key leader is very important. Basically, it is the personal trust towards the key leader.”); Interview No. 3 (Sept. 30, 2008), at 5. (“When I’m considering accepting this position (as an independent director), I will first see who invites me to join the board. He should be the one whom I can trust because I need to be extra cautious when taking on such responsibility.”)
35 Interview No. 7 (Oct. 12, 2008), at 3.
the independence of the “independent” directors.

Just as an independent director is afraid of joining a “bad” company, a controlling shareholder is also worried about inviting a “bad” outsider to the board. Different controlling shareholders might provide different definitions for a “bad” independent director. Controlling shareholders would then, according to their own criteria, screen their own “good” independent directors. A firm that truly honors corporate governance would seek a truly “independent” director and provides him/her with abundant resources to do his/her job. For example, Taiwan Semiconductor Manufacturing Company (TSMC), a leading company in promoting corporate governance, searches for candidates through law firms and accounting firms, instead of finding someone they personally know; they look for candidates who are established in their respective fields of practice and have expertise that is helpful to the company. On the contrary, a firm that only wants a window-dressing director would find someone who is willing to be a rubber stamp for board decisions.

The reality is that, except in a few large companies, most leaders of the public companies in Taiwan generally seek independent directors of whom they personally know. As mentioned, controlling shareholders would seek for their own “good” independent directors. There also exists information asymmetry between candidates and controlling shareholders about the quality of independent director candidates. Guan xi (relationship) has been an important source of reliable information in Chinese society. Therefore, it is no surprise that controlling shareholders would first invite someone who has the guan xi to join the board.

Nevertheless, guan xi might compromise independence. Commentators in several regions, such as China, India and Taiwan, have cast doubt on the independence of
independent directors.\textsuperscript{36} Their close relationship with controlling shareholders is definitely one of the major concerns.

In many companies, the so-called independent directors are invited by the controlling shareholders. In addition, many of them maintain good relationship with the major shareholders and executives. They (the independent directors) might politely remind the management (of some pitfalls) to a certain point. However, I think the role of these (independent) directors is limited.\textsuperscript{37}

Among the 40 independent director interviewees, 19 of them used the term “very close friend” to describe their relationship with the controlling shareholders or CEOs and 14 of them personally know the controlling shareholders or directors but are not very close friends. Only 7 of the interviewees did not know the controlling shareholders or other inside directors before they were invited to join the board. Although the statistical results cannot be generalized due to limited number of samples, most interviewees agree that a majority of the independent directors have some guan xi with the controlling shareholders.\textsuperscript{38} Then the question presented would be “Does guan xi matter with regard to director independence?”

\textbf{Structural Bias}


\textsuperscript{37} Interview No. 18 (Feb. 18, 2009), at 2.

\textsuperscript{38} Interview No. 3 (Sept. 30, 2008), at 1; Interview No. 4 (Oct. 7, 2008), at 1; Interview No. 18 (Feb. 18, 2009), at 2; Interview No. 20 (Feb. 19, 2009), at 1; Interview No. 21 (Feb. 25, 2009), at 1.
It is a common concern that an independent director might be biased in making decisions if he/she has guan xi with controlling shareholders. Such concern is underpinned by the theory of structural bias which suggests that even if an independent director does not have financial or employment ties with the firm, he might still be biased in making decisions because of the social pressures generated from his personal relationship with the management or controlling shareholders. The U.S. scholars have long been aware of the social and psychological causes of bias that could impair independent directors’ impartiality. Hwang and Kim (2009) examine the social ties among board directors of Fortune 100 firms and the impact of social ties to executive compensation. They identify social ties by mutual alma mater, military service, regional origin, discipline and industry, and find that the percentage of independent boards drop from 87% to 62% when screening by social ties. In addition, the CEOs of socially independent boards receive significantly lower compensation than those of non-independent boards, suggesting that social ties and structural bias do matter in corporate governance.

However, the U.S. Delaware courts believe that most friendships are not to a level where they create bias towards decision-making. In determining the independence of directors in shareholder derivative actions, the Delaware courts apply a case-by-case

41 Byoung-Hyoun Hwang and Seoyoung Kim, It Pays to Have Friends, 93(1) J. FIN. ECON. 138 (2009).
42 Id., at 139-44.
43 Id., at 145-48.
44 “But, to render a director unable to consider demand, a relationship must be of a bias-producing nature….Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence…. [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend. Not all friendships, or even most of them, rise to this level…..” Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004).
approach, presumed the independence of a director, and posed a demanding standard in refuting such independence. However, in addition to financial interests, the Delaware courts do rebut the independence of directors if they find close social or professional relationships among directors. More challenges based on personal relationship have been raised recently to question the independence of directors in cases involving demand excusal in a derivative suit or the application of the business judgment rule. It is expected that the extent to which personal relationship compromise director independence will continue to develop in Delaware case law. Furthermore, scholars have also called for more judicial power in reviewing the substantive merits of independent directors’ decisions in cases involving structural bias.

However, from the economists’ point of view, directors would try hard to avoid such bias in order to preserve their reputation in the independent director market. Therefore, even if bias could arise from friendship, it is avoidable. While the above reputation argument is based on an assumption that directors are well aware of their biases, contemporary psychological research studies recognize another prototype of bias —

45 “Independence is a fact-specific determination made in the context of a particular case.” Id. at 1049. See also Elizabeth Cosenza, The Holy Grail of Corporate Governance Reform: Independence or Democracy?, 2007 BYU L. REV. 1, 29-41 (2007).
46 See Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) (questioning the independency of the two members of the special litigation committee due to their longstanding personal ties with the defendant director); In re Oracle Derivative Litig., 824 A.2d 917 (Del. Ch. 2003) (finding a lack of independence of the members of special litigation committee because of the Stanford ties among several directors).
47 Justice Randy J. Holland, Delaware Director Independence, Speech at the Taiwan Law Society 17 (Dec. 4, 2009).
“unintentional bias”.50 Unintentional bias concerns bias that results from unconscious cognitive processes.51 Because such bias is “involuntary” and “unconscious,” it can occur even when the decision maker intentionally seeks to avoid biases.52 Commentators argue that since decision makers are not aware of such bias, the reputation argument supported by economists thus could not be sustained.53

Given the existence of unintentional bias and the increasing awareness of the impact of personal relationship on director independence in the Delaware courts, the issue of structural bias deserves more attention in countries which have transplanted the institution of independent directors from the U.S. The close relationship between independent directors and controlling shareholders is not a unique phenomenon in Taiwan, rather it is a common issue faced by most Asian countries. Commentators have also claimed “truly independent directors are rarely found in Indian companies” based on the fact that “board members are selected by the promoters on the basis of existing contacts.”54

In Taiwan, as in many other Asian countries, there does not exist a sophisticated commercial court and complementing legal system to provide the kind of ex post judicial review found in the U.S.55 For example, a shareholder derivative suit is almost unheard of in practice due to the various procedural hurdles set in the Company Law of Taiwan. In addition, the business judgment rule has yet to be accepted by the Taiwanese court. Because of these very different local conditions, ex post judicial review of director independence not only does not exist in the current legal system but also is unforeseeable

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51 Unconscious bias could exist in every stage of the cognitive processes, from the starting point, reasoning, to information processing. Id., at 259-285.
52 Id., at 258.
53 Id., at 285-286.
54 THE HINDU BUSINESS LINE, supra note 36.
55 Gilson and Milhaupt, supra note 1, at 369-372.
in the near future. On the flip side, the Taiwanese legal system has yet to recognize the role of independent committees in resolving conflicts of interests, which in turn limit the function of independent directors and the value they could have created. This is exactly the danger of legal transplantation. While the transplanted country has yet to have the soil to nurture the precious seed, it must either fertilize the soil or plant another seed that would fit in order to enjoy the flower blossom.
Conclusion

Public regulation does change the landscape of corporate governance in Taiwan. As of October 2009, 38.2% of the TSE-listed companies have at least one independent director on their board. However, among these companies, only very few companies truly welcome independent directors and expect them to actively participate in corporate matters. It is fair to say that the new regulation has created a market for independent directors in Taiwan. Nevertheless, it does not change much of the substantive corporate governance practice in Taiwan.

As compared with the independent directors in the U.S., the participation of independent directors in Taiwan is relatively limited. The value of independent directors in reconciling conflicts of interest matters has not been recognized by Taiwanese public companies. The existence of statutory supervisors further weakens the monitoring function of independent directors. Furthermore, there exists tremendous information asymmetry between independent directors and controlling shareholders, in particular, the shareholder managers. To overcome information asymmetry, independent directors in Taiwan generally choose to join a board with which they are familiar. The interview results reveal that independent directors generally maintain close social relationships with the controlling shareholders. Thus, there is concern that bias arising from the social ties could hinder the independence of directors.

Transplantation is a long process where new legal measures grind against pre-existing local conditions. Taiwan is still in a transition period where one-third of listed companies operate under a dual board system with independent directors on the board. Independent directors were put on an advising board for some monitoring tasks while there exists
another institution, the statutory supervisor, still in charge of corporate oversight. In
addition, without complementary judicial deference to the decisions of independent boards,
the value of independent directors to the firm greatly diminished. All these existing local
conditions present challenges to the new legal device and hinder the transplantation
process.